

POLITICAL RISK ANALYSIS FOR BUSINESS
IN HONG KONG
BEFORE AND AFTER 1997

by

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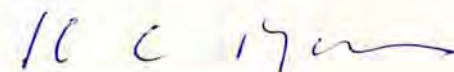
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ABSTRACT

July 1, 1997 is a crucial day for Hong Kong as Britain will hand back the territory's sovereignty to China on that day. This issue has been confronting Hong Kong for years but the effect of it to Hong Kong remains unclear. As the day draws closer, more foreign firms become reluctant to invest in the territory while domestic companies continue to diversify overseas seeking for foreign domiciles and secondary listings on other stock exchanges. Before June 4 in 1989, most people believe Hong Kong will continue to prosper. After the Tiananmen Square Incident, less people tend to retain the same belief.

It is the purpose of this research report to analyze the political risk environment in Hong Kong from the opinion of six selected business executives, who acted as experts for our survey, and to show how such environment would be affected by the 1997 issue. A comparison between the political risk environment in Hong Kong before and after 1997 is also studied. It is generally believed, according to the executives, that Hong Kong's political risk environment will worse off after 1997 but is expected to stabilize as time goes by. Finally, the risk avoidance policies proposed by the business executives to reduce the political risk in Hong Kong will also be discussed. Joint ventures with foreign firms, reduce fixed assets, international diversification of investment are the several most common means they adopt to reduce their risk.

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Hong Kong

CHAPTER I

INTRODUCTION

The 1997 issue has been confronting Hong Kong ever since the signing of the Sino-British Joint Declaration in 1983. At that time, people were optimistic about the future of the territory. Business firms shown little concern about the investment climate in Hong Kong because they believe the territory was going to have a bright future. But the pro-democracy Student Movement in Beijing aroused most people in Hong Kong to pay more attention to the future of the territory. People began to wonder if China would keep its promise to maintain the policy in Hong Kong for fifty years after 1997. Business firms began to think twice before they invest in the territory. People who do not have confidence in China plan to emigrate overseas. Business firms who doubt whether Hong Kong could continue to prosper have partially, or even wholly, diversify their investment to foreign countries.

The purpose of this research report is to review the past literature as well as current issues on political environment in Hong Kong, and to present opinion of six selected businessmen towards the major political risk in the territory. By briefly reviewing the articles in the next two chapters, we define the meaning of political risk, identify the risk assessment method and formulate the political risk framework which are tailor-made for the business environment in Hong Kong. Later, in chapter 4, the methodology we use for this research is also described. Finally, in chapter 5 and 6, the results obtained are analyzed and some proposed risk avoidance policies for business firms in Hong Kong are also studied.

CHAPTER II

LITERATURE REVIEW

Definitions of Political Risk

The past decade saw numerous publications about political risk. Yet, the meaning of political risk is still confusing as it often gets mixed up with other non-political risks such as economic and social risks. Besides, different people tend to perceive political risk in different ways. Literally, political risk refers to "the business risk brought about by political sources or environment." Nevertheless, the concept of risk and political sources/environment are not at all easy to define.

A review of past literatures discovered the following meanings of risk:

1. Chance, possibility, or probability of loss (Baglini 1976).
2. Probability of future occurrence of events or acts (Nehrt, 1970; Overholt 1982; Poynter 1984).
3. Actions adverse to foreign investment (Jones 1984).
4. Potentially significant managerial contingencies (Kobrin 1982).
5. Changes in the operating conditions (Jodice 1984).
6. Probability that events, changes, and conditions will impact on business operations and goals (Lax 1983; O'Leary and Copley 1983).
7. The multiplication of the size of a potential loss by the probability that the loss will occur (Nagi 1987).

As for the meaning of political sources and political environment, its distinction from that of non-political is far from clear cut.

According to Robock (1971), political risk are generated by the following sources:

- (1) government in power and its operating agencies.
- (2) parliamentary opposition groups.

- (3) non-parliamentary opposition groups.
- (4) non-organized common interest groups.
- (5) foreign government or inter-governmental agencies.

In other words, risk events generated by sources other than any of these five categories would be classified as non-political and is not the interest of our study.

In this research report, we will define political risk as all unwanted consequences adverse to business and is brought about by political sources or environment as defined by Robock. The unwanted consequences include the economic and societal disturbance caused by political risk and/or uncertainty. As a matter of fact, businessmen are usually more interested in the economic consequences of political decisions.

Political Risk Assessment Methods

Political risk assessment refers to a systematic means of assessing and managing the political risks of foreign direct investment or international business (Micallef 1981).

Similar to having various definitions of political risk, there also exists various techniques to assessing political risk.

Generally speaking, political risk assessment can be classified into two big categories: Qualitative and Quantitative. Of the qualitative approaches are:

- (1) Grand Tours.
- (2) Old Hands.
- (3) Delphi Techniques.

while the quantitative approaches include:

- (4) Order Ranking
- (5) Decision Tree
- (6) Multiple Regression
- (7) Discriminant Analysis.

These are just the most popular ones in current use for political assessment and, of course, there are many more. As a matter of fact, reliance on any single one of them is hardly adequate nor accurate. That's why some

scholars suggested to use integrated approach, i.e. a combination of two or more approaches, when deal with political assessment. Nevertheless, we will start by briefly introducing all the fore-mentioned approaches.

Grand Tour: This is a simple but rather expensive approach. It starts by doing some preliminary market research and then dispatches an executive or a team of people on an inspection tour. Local officials are contacted and the political landscape is surveyed. This grand tour approach, however, may suffer from an overdose of selective information. The company observers may be insulated from the political and economic realities of the country visited.

Old Hands: Multinational corporations can seek to acquire area or country expertise from seasoned educators, diplomats, journalists, or businessmen, or to retain such experts on a consulting basis. The capability and experience of the advisers often determines the quality of report. Even the experts make mistakes, sometimes.

Delphi Technique: This is a more systematic approach to political risk analysis than the preceding two and is sometimes referred to as "Expert Opinion Poll." A wide range of experts are selected and asked separately to identify and answer a list of selective elements or questions concerning political risk. All answers or view-point proposed by the experts are then presented to each and every one of them as reference and the experts are then asked to identify or answer the same elements and questions again. The experts can base on the answers given by others to modify his own answer. This process is repeated several times until a set of agreed answer is resulted.

The fore-mentioned approaches are quite popularly used in many companies but the current trend in risk assessment methodology is to use "hard data", i.e. quantitative approaches, rather than subjective analysis. Such quantitative approaches are discussed below:

Order Ranking Technique: This approach is a use of index for ranking purposes. Among the worldwide most popular ones are:

1. Business International's (BI) Index of Environmental Risk, which surveys 75 countries twice a year on 55 factors. The assessment is conducted by a group of specialists from each country and BI's employees. All countries are assessed and

ranked on a composite scale according to the degree of risk, opportunity, and operating conditions.

2. Business Environment Risk Index (BERI), which assigns a numerically estimated risk rank, based on 15 risk criteria, to 48 countries semi-annually. A permanent panel of experts ranks each country three times a year on a Likert scale.

3. Political System Stability Index (PSSI) which is composed of three equally weighted subindexes namely socioeconomic, governmental process, and societal conflict indexes.

4. Frost & Sullivan’s Political Country Report (PRCR) which prepares quarterly reports on 80 countries based on 210 independent political analysts, businessmen, officials, political scientists and other country specialists.

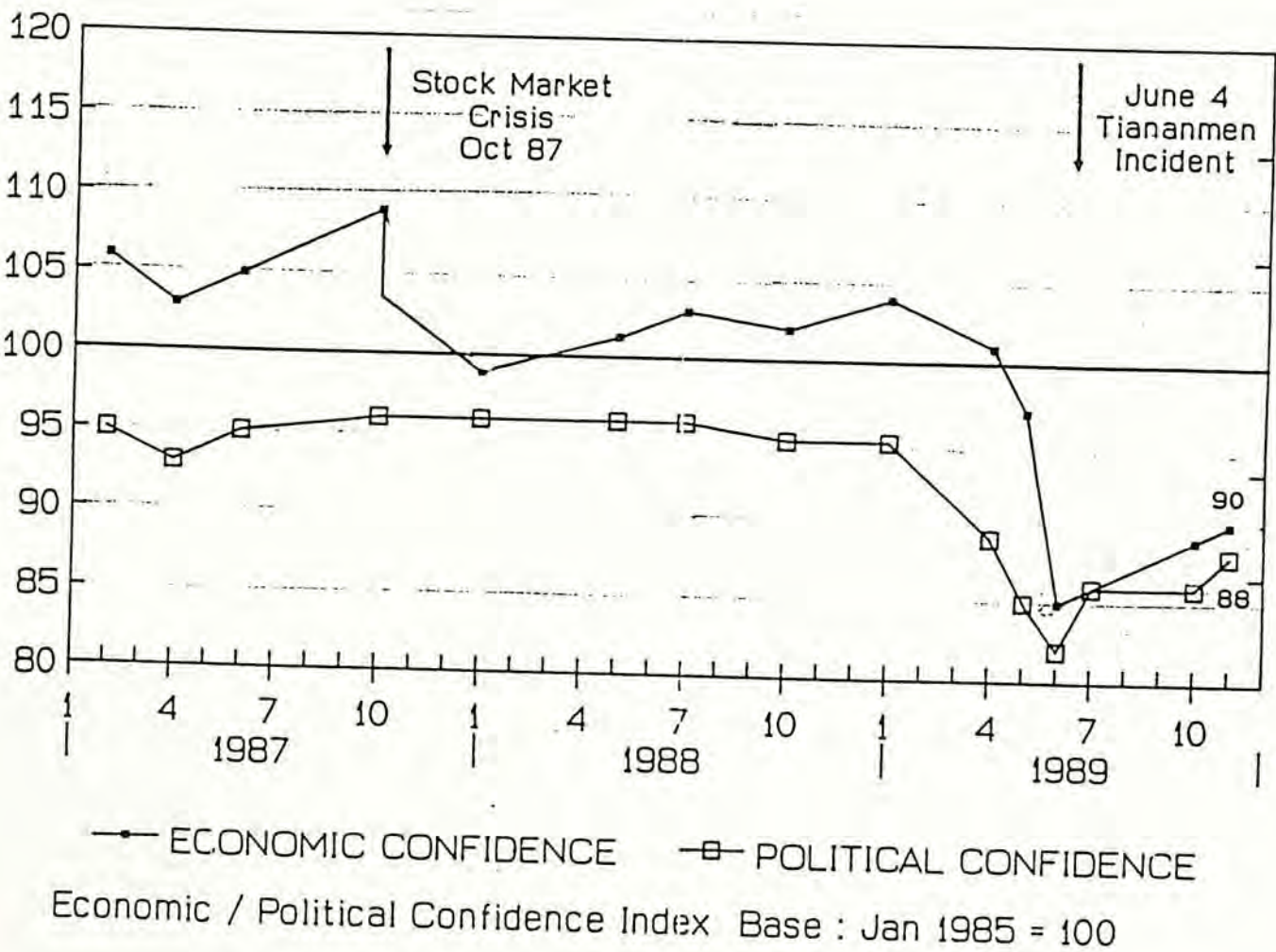


Figure 1. SRH Confidence Index

Similar indexes are also available in Hong Kong. One such index is the Survey Research Hong Kong (SRH) Confidence Index which, with a base of 100 points, is a poll to measure political and economic confidences for local people in Hong Kong. The poll started in 1983 after the signing of the Sino-British Joint Declaration. According to this survey, the confidence level reached its lowest point on June 1989 during which the Tiananmen Square Incident occurred. The index also revealed that even in February 90, eight months after June 4, both economic and political confidences were not much better than in July 89, a month after the Tiananmen Square Incident. This is rather unlike other indicators such as property prices and incoming visitors which reclaimed most of their losses rapidly.

Another organization which perform regular survey for Hong Kong is the domestic based Political and Economic Risk Consultancy which ranked the Asian countries according to their comparative country risk. The consultancy's system gives a 30% weighting to market size in its model, a similar weighting to the potential for economic changes and a 40% weighting to chance socio-political changes. According to their latest report on March 1990, China, the Philippines and Indonesia are the highest risk nations for business and investment in the Asian region. China is by far the riskiest country for social unrest. Hong Kong's risk level has blown out to behind Japan (the most stable Asian country) and Singapore (the second) since the last assessment by the group, not principally for domestic reasons, but because of its close ties to the mainland and the political and economic events in China throughout this year.

The common threat in the political risk indexes of the rank ordering approach has been a reliance on expert-generated data. The problems of using them being:

- (1) The underlying assessments of the scoring and weighting, and even the definitions of the key indicators are not revealed, making it impossible to replicate the assessment and get the same result.
- (2) There is a lack of consensus among the raters of different indexes. A perfect example is illustrated by Friedmann & Kim which is reprinted in Figure 3.

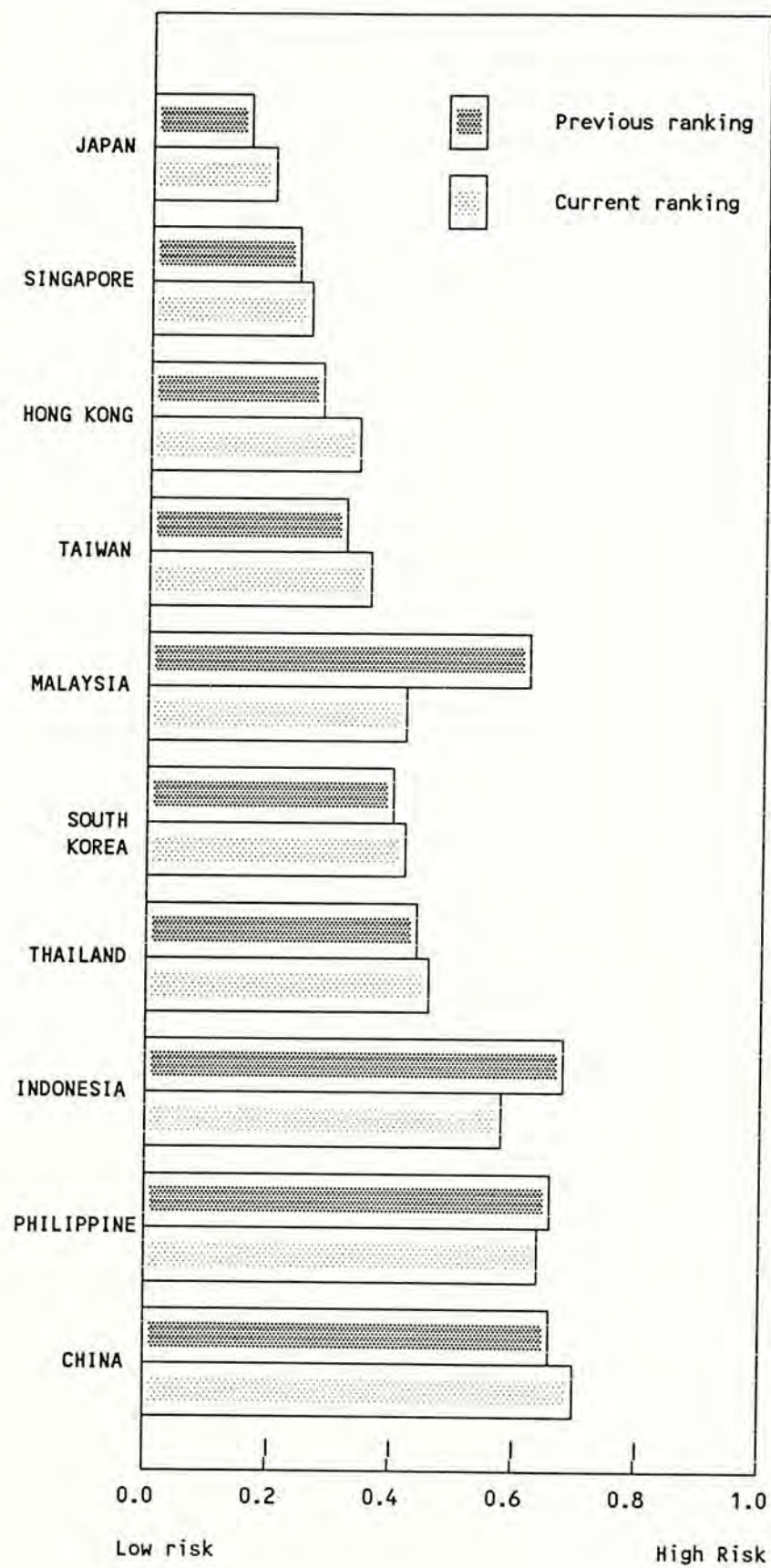


Figure 2. Comparative Country Risk

| TEN BEST POLITICAL RISKS IN 1985 | | TEN WORST POLITICAL RISKS IN 1985 | |
|---|---|---|--|
| According to PRCR: | According to BI: | According to PRCR: | According to BI: |
| United States Denmark France Finland West Germany Austria Canada Japan England Netherlands | Singapore Netherlands Norway South Korea Saudi Arabia Switzerland West Germany Britain Spain Japan | El Salvador Iran Nicaragua Zaire Zambia Libya Bolivia Egypt Pakistan Philippines | Iran Yugoslavia Sudan Algeria Mexico Nicaragua Chile China Thailand Philippines |

Source: Roberto Friedmann and Jonghoon Kim, "Political Risk and International Marketing," *Columbia Journal of World Business*, Winter 1988, P.63-74.

Figure 3. The Ten Risk-free and Ten Excessive-risk Countries

Decision Tree Approach: This is used not to assess prospective investment climates but instead to estimate the probable occurrence of some political events and map out sequences of strategies for corporate executives in existing investments. The problem with this approach is that it is difficult to estimate the expected value of political events because subjective judgements are involved in determining the probability coefficients. Besides, it is very time consuming and frustrating to assemble an exhaustive list of causal factors and possible outcomes.

Multiple Regression Analysis: This method predicts future political trends on the basis of past conditions. The advantage is that it is relatively simple, statistical tests provide insight in determining which indicators have more predictive power, the estimated equation coefficients provide indicator weighing. However, if the selection of the indicators is not based on a well-grounded analytical framework, the results could lead to faulty decisions. One more defect about multiple regression analysis is that it assumes there is a linear relationship between the past and future conditions. Nevertheless, it is possible that there could be a curvilinear relationship or simply that the future may not be an extension of the past.

Discriminant Analysis: This last approach can solve the curvilinear relationship or multicollinearity problem that multiple regression approach cannot tackle. The discriminant analysis puts the countries under study into mutually

exclusive groups based on particular attributes. The number of such attributes are determined by the political analysts and countries are expected to differ on the attributes. The discriminant coefficients and the determining variable statistically chosen for significance are then used to make future projections or to assess the creditworthiness of a country or the propensity of its leaders to expropriate foreign firm.

There isn't without limitations for discriminant analysis. The assumption behind this approach is that there must be two or more statistically distinct groups of countries. In reality, however, countries may form a continuum to political risk conditions. Since this approach concerns about the two extremes only, countries of borderline cases are very difficult to predict. Some countries may be falsely identified as risky when actually they are countries profitable for investment. Over reliance on this approach can result in missed opportunities.

All of the fore-mentioned approaches are applicable for the situation in Hong Kong if only the 1997 issue is absent. Technically speaking, Grand Tour, Delphi Technique, Order Ranking and Discriminant Analysis are approaches that measure only the current status of political environment in Hong Kong while the rest, except Decision Tree Approach, try to infer the future environment based on the past. However, the 1997 issue is so drastic a change that using the past to infer future is doomed to be invalid.

Only Decision Tree Approach takes into account different possibilities of things in the future but, as mentioned earlier, it is rather frustrating to assemble an exhaustive list of causal factors possibility outcome, especially when the future is so unclear.

Each approach seems to have its pros and cons in assessing the political risk and that's why some scholars reasoned that any single one of the fore-mentioned approaches is insufficient and that a combination of them be necessary if accurate result is expected.

Political Risk Frameworks

Frameworks to assessing political risk are also many but we will only discuss the representative ones in this report.

Friedman and Kim's model (1988) classified risks into three types: Operational, Ownership and Transfer. Operational risks refer to the adverse effects in the operations of a company, including its production, marketing and personnel activities. Ownership risks refer to those influencing the position and the volume of the investment. Transfer risks are those that restrict the transfer of money or fixed assets in and out of the host country.

Robock, in early 1970s, proposed another general framework for political risk assessment. He distinguished between actions and policies directed at all foreign enterprises in a given country, characterized as "macro" political risks, and those aimed only at selected fields of foreign business, labelled "micro". In addition, the anticipation of political risk can be aided by distinguishing between societal and governmental related actions and policies, as well as between internally and externally based events. In short, Roback's political framework was distinguishes three dimensions:

- (1) Macro and micro political risk.
- (2) Societal and governmental related actions and policies.
- (3) Internally and externally based events.

A similar but more comprehensive framework for identifying and anticipating different types of political risk of a country was developed by Simon (1984). His framework is concerned primarily with the identification, analysis, and management of political restraints on foreign investment, with main political risk, as well as on the interrelationships of strategies, goals, and capability of the company.

Basically, the framework differentiates four main dimensions:

- (1) Open and close societies.
- (2) Industrialised and developing countries.
- (3) Direct and indirect risk.
- (4) Internal and external sources of risk.

The first dimension, i.e. open and close societies, describe the degree of openness in its socio-political system. The second dimension, i.e. industrialised and developing countries, describes the stage of economic development. These countries will differ in their overall orientation towards foreign business.

According to this model, Hong Kong can be categorized as open and developing. Theoretically, the open-developing framework proposed by Simon is applicable to Hong Kong. The problem, however, the political risk factors listed by Simon are a bit too general. In order that the framework can be used for Hong Kong, the political risk factors must be modified so that the situation in Hong Kong can be applied.

In this research report, we will base on the four dimensions used by the framework proposed by Simon to examine the local political risk environment. The modified model for Hong Kong is formulated and shown in Figure 4.

| | | Developing | |
|------|----------|---|---|
| | | Internal | External |
| Open | Direct | Economic stability Currency convertibility Restriction on capital/profit repatriation Labour shortage Labour productivity | Economic recession Exchange rate stability |
| | Indirect | Policy stability Brain drain Social demonstration Riot Government structure Price stability | Change of political leaders Relations with China Relations with foreign countries |

Figure 4. Political Risk Framework for Hong Kong based on Simon’s model.

Political Risk Avoidance Policies

No firms can completely eliminate political risk. Once a firm starts to operate, the firm is exposed to political risk. However, political risk is not all unavoidable. If a company takes good measures to research before starting

business in a region, chances of being a victim can definitely be minimized.

Typical methods for political risk avoidance are diversification of investment and continuous monitoring of situation changes as political environment is very volatile. In addition, Brenner, in 1981, suggested some useful but rather low profile techniques to avoid political risks. Among them are: Joint Venture with Local Partner, Use Local Resources, Dependence on Parent Company and Be a Good Citizen under the host's political policy. Micaffel, on the other hand, suggested in the same year that Joint Venture with Foreign Firms and Seek International Financing are also useful for political risk avoidance.

Poynter, in 1982, however, stated that multinational firms should take a more aggressive role in dealing with political risk. He suggested that multinational companies should maintain operation and managerial complexity so that even if local government want to nationalise the company they can hardly continue its operation. In addition, the firm should also control sourcing, export distribution channels, and the skill to operate to make it even harder for the local government to nationalize its investment.

Friedmenn and Kim, in 1988, advised a more scientific approach which suggested a typology of goods and services that have historically been affected by political risk events be developed. Such a typology would allow for better evidence in researching casual relationships and even assessing contingency strategies to political risk. A higher local ingredients or components of products is also recommended to reduce exposure to potentially damaging political risk events such as tariffs, quotas, or regulations which could more radically affect the products.

In summary, methods to prevent political risks are:

- (1) Close down business
- (2) Reduce fixed assets investment
- (3) Increase local borrowing
- (4) Increase foreign financing
- (5) Joint venture with foreign firms
- (6) Joint venture with local companies
- (7) International diversification of investment

- (8) Control sourcing of raw materials
- (9) Control knowledge/skill to operate
- (10) Control export and distribution channels
- (11) Adapt to local political policy

All of these avoidance methods are applicable to Hong Kong and thus will be surveyed in our research.

CHAPTER III

CURRENT ISSUES

Economic Stability

For many years, Hong Kong has enjoyed the reputation as one of the finest international business centres in Asia. Its perfect location as a gateway to China, where there is plenty of market potential to be explored, attracted business firms from all over the world to invest in Hong Kong. Hong Kong also enjoys the best logistics, communication and transportation which makes the territory a trade centre competing with Japan and Singapore.

| Year | Per Capita GDP at constant (1980) market price (HK\$) | Per Capita GDP at current market price (HK\$) |
|------|---|---|
| 1980 | 27,075 | 27,075 |
| 1981 | 28,936 | 31,827 |
| 1982 | 29,350 | 35,393 |
| 1983 | 30,785 | 38,832 |
| 1984 | 33,374 | 46,079 |
| 1985 | 32,980 | 47,871 |
| 1986 | 36,393 | 54,372 |
| 1987 | 40,822 | 65,589 |
| 1988 | 43,267 | 75,214 |

Source: Hong Kong Monthly Digest of Statistics

Figure 5. Real and Current GDP per capita in Hong Kong.

After the Tiananmen Square Incident in 1989, Hong Kong saw a lot of changes economically to the territory. Due to the incident, many people lost confidence in China. Businessmen in Hong Kong began to suspect if Hong Kong, whose sovereignty will be handed back to China after 1997, could continue to prosper. People also saw the relationship between China and U.S. began to deteriorate. Since China and U.S. are the two largest trade partners of Hong

Kong, their deteriorating relationship would mean Hong Kong to hurt the most.

Uncertainty concerning the future of Hong Kong also caused a lot of people to immigrate to foreign countries. This poses a even more serious problem of labour shortage, which has already been a problem for Hong Kong for several years. Many business firms also decided to seek for foreign domiciles and secondary listings on other stock exchanges. As a result, Hong Kong's regional role in financial services is under threat, particularly from Singapore and Japan which are constantly taking away Southeast Asia and North Asia business from Hong Kong. If this situation continues, it is estimated that Hong Kong will in future be reduced to a service centre primarily for China and Taiwan rather than for the rest of Asia as well.

According to Business International Forecasting Services Group, Hong Kong's economy is expected to remain sluggish during the coming year, with uneven export demand and a persistent labour shortage which has hindered business expansion. The group attributes the current downturn in the economy to the world economy reaching a new low point in the business cycle and the slowdown in China's economy as a result of last year's prodemocracy crackdown in Tiananmen Square. However, the Group is expecting the economy to revive in the very near future which it will be in line with an anticipated global upswing.

Exchange Rate Stability

Hong Kong dollar is linked to the US dollar at an exchange rate of approximately US\$1 to HK\$7.8. That means Hong Kong will follow the fluctuation of U.S. in the foreign exchange market and can be traded like the U.S. dollar in most countries in the world. This is achieved by buying and selling of foreign currencies using the foreign currency reserve. In this respect, Hong Kong dollar is considered to be very stable towards U.S. dollars. With respect to other currencies, Hong Kong dollar is as volatile as the U.S. dollar.

In fact, there isn't without pressure to the tie between U.S. dollar and Hong Kong dollars. In case Hong Kong's economy worse off to such a level that no more people would like to hold Hong Kong dollars any more, it is very likely that such linkage will break.

Currency Convertibility

Since Hong Kong dollar is linked to the U.S. dollar at a fixed exchange rate, as discussed in the preceding section, and can be traded freely for any other currencies all over the world. Unfortunately, this is not so for Chinese Yuan.

After 1997, Hong Kong's sovereignty is handed back to China. Can Hong Kong dollar still be traded freely in any places all in the world? We will find out this from the business executives' points of view in this research.

Price Stability

Generally speaking, stability of price refers to the possible fluctuation of domestic prices. A decrease in price means worth of money increases. The reasons accounted for this is lowered cost due to improved technology, increased labour productivity and cheaper raw material, components and parts. Advantages of price decrease is that people can buy more with a fixed amount of money. The territory can also become more competitive in the world market.

On the other hand, an increase in price means money worthies less and the territory would become less competitive. Price increase can generally be indicated by inflation which in term can be inferred by consumer price indexes.

According to data obtainable from Government Census and Statistics Department, the three Consumer Price Indexes and their growth rates in Hong Kong for the past five years are listed in the Figure 6.

High inflation would decrease Hong Kong competitiveness, lower workers' standards of living and erode savings. Under a high level of price inflation, workers' living standard can only be compensated by urging for higher wages which, unfortunately, may further push price inflation to a even higher level.

The past few years saw a rapid level of wage inflation in Hong Kong from 3% in 1985 to 10% in 1990. Such a high level of wage inflation was not a problem for Hong Kong when Hong Kong's economy was also growing, with increased investment and increased production and, more importantly, increased productivity to pay the higher wages. But when the economy begins to slow down, which is likely the case in 1990s, and demand for goods and service falls

| | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|-------|----------------|----------------|----------------|------------|
| Consumer Price Index (A) Growth Rate | 101.4 | 103.7 2.27% | 109.4 5.50% | 117.5 7.40% | 132.6 * |
| Consumer Price Index (B) Growth Rate | 101.6 | 104.0 2.36% | 109.5 5.29% | 117.6 7.40% | 132.1 * |
| Hang Seng Consumer Price Index Growth Rate | 102.3 | 105.7 3.32% | 112.5 6.43% | 122.3 8.71% | 139.7 * |

NOTE: The three Consumer Price Index series were derived from the Household Expenditure Survey conducted in 1984-85. They are defined in terms of the percentage distribution of households by expenditure as follows:

| Index | Approx. of Household covered | Monthly expend. in 84-85 |
|---------------|------------------------------|--------------------------|
| CPI(A) | 50% | \$ 2,000 - \$ 6,499 |
| CPI(B) | 30% | \$ 6,500 - \$ 9,999 |
| Hang Seng CPI | 10% | \$10,000 - \$24,999 |

* Data extract from Government Census and Statistics Department.

Figure 6. Consumer Price Indexes.

off, the opportunities for greater output, greater efficiencies and greater productivity are less. Then, higher wages can become damaging by pushing up the costs of businesses which are unlikely to pass their higher costs on in a declining market.

Businessmen are usually more concern with increase in price of raw materials or parts/components since these are directly related to the cost of products they manufacture and/or market. Hong Kong can save some increase in inflation as a result of the devaluation of the Chinese yuan and the impact it has on imports from the mainland but this will not help control domestically driven inflation in the territory. It may become even more important when demand for Hong Kong's goods and service is not just slowing in the domestic market, but the world market as well.

Some remedies to combat inflation are:

(1) Permission for importing labour because they are cheaper than most local labour. This measure can also help solve the refugee problem because they are also cheaper than the locals.

(2) End the Hong Kong-US dollar peg. Hong Kong dollars should be linked to a basket of strong currencies rather than keeping it tied just to U.S. dollars.

Restriction on Capital/Profit Repatriation

Currently, there is no restriction on capital/profit repatriation in Hong Kong. Thanks to this policy, foreign firms are happy to invest in the territory.

Due to the uncertainty in Hong Kong after 1997, more and more firms are moving away to set core activities elsewhere, taking away with them all or part of their capital/profit. This clearly indicates that many business firms fear there may be restriction on capital/profit repatriation after 1997. If, however, it is found that such restriction on capital/profit repatriation in Hong Kong after 1997 does not exist, then capital may stop to flow away and even those that have flown away may flow back.

Economic Recession

A economic recession is a decline in total output, income, employment & trade, and it is usually marked by widespread contractions in many sectors of the economy.

Hong Kong is not a self content city and depends heavily on trading. Most of the locally needed raw materials and parts are imported from foreign countries while a high percentage of local production is for export purposes. In case of any possible economic recession, Hong Kong may have to stand more on its own and thus its economic environment is doomed to be adversely affected.

Labour Productivity

The key to economic growth is an increase in productivity. When a typical worker produces more in an hour, the labour productivity increases. However, this must be associated with reasonable growth in wage inflation. If wage growth is faster than output increase per worker, then such labour productivity will not be justified. As a matter of fact, labour productivity in Hong Kong is considered to be very good compared to other nations in Asia but this may become no longer justified by a high level of wage inflation in recent years.

Many companies, especially manufacturers competing in price, decided to

move their production plants into China where cheap labours are readily available. Leaving behind high value added manufacturing activity of which real output per worker stayed constant at approximately nine percent increase per year in the period 1980-87 while real output per worker in services sector increased only three per cent in the same period.

Change of Political Leaders

When we talk about political leaders in Hong Kong, we refer to three kinds of political leaders. They are political leaders in Hong Kong, Britain and China.

The Governor, i.e. Sir David Wilson, is by far the closest to Hong Kong yet he has the least power in determining the future of the territory. Since the Governor is appointed at the pleasure of the Crown, there would be no constitutional difficulty in replacing him as well. He is also directly responsible to the Foreign Secretary in London and thus he is closely constrained in what he can do. According to Mr. Norman Miners of the Political Science at the University of Hong Kong, there is even more limitation posed to the governor in accordance with the Sino-British Joint Declaration which stated that all important issues of internal policy should be discussed and settled by agreement at meetings by both the Chinese and British sides. In this sense, Britain's policies in Hong Kong are only part of its policy towards China.

Mrs. Thatcher, of the Conservative Party, is currently the leader of the British Parliament. The Conservative Party has shown an admirable firmness in administering Hong Kong in spite of popular opposition about the nationality package by the Labour Party. So long as Mrs. Thatcher remains Prime Minister, there is no danger of abdication of imperial responsibility in Hong Kong. The problem is, as a recent poll conducted in Britain, that popularity of Mrs. Thatcher hits the lowest point of all Prime Ministers in history. If the Labour Government returns to power at the British general election in 1992, it is possible that such attitude towards Hong Kong may change.

As for China, change of political leaders is the most difficult to predict. To make things more complicated, the one who is in charge may not necessarily be the one with highest authority. For example, the current number one leader

in China is Jiang Zemin but it is believed that Deng Siu-peng still has the greatest influence over the policies in China.

The current situation in Hong Kong is that most of Legislative Councillors are appointed rather than elected. But people generally agreed that more direct election implies more autonomy to Hong Kong after 1997. That's why Hong Kong residents are fighting for a faster pace in direct election before 1997.

Policy Stability

We believe the change of political leaders and the policy stability are highly correlated. If the governmental structure and the leaders in power do not change, the policy should be very stable (Of course there are exceptions). Therefore, policy stability depends very much on stability of leaders in power.

The government in Hong Kong advocates a laissez-faire policy and leaves its hands off the economy as much as possible. The business environment is free and flexible. Some even attribute the laissez-faire policy to the economic growth and equity in Hong Kong. Looking ahead, one expects little change in the fiscal and monetary policy, in the tax structure, in the form of business regulations in the years before 1997 when the sovereignty of Hong Kong is reverted to China. However, one cannot help noticing the increasing noises and concern on the political structure of the government after 1997 since China is such a source of risk.

As Mun and Ho (1979) suggested that the political situation of Hong Kong is almost entirely decided upon by Beijing. This is readily shown by the downgrade of Hong Kong issued bonds from A2 to A3 when China's rating dropped from A3 to BAA1 after the Tiananmen Square Incident. Hong Kong's economic future is dependent on China's intentions towards the territory and its ability to carry out those intentions.

Brain Drain

The term brain drain refers to the loss of professional expertise or skilled labours to overseas countries by emigration. This is a serious problem because the success of a society depends on the presence and commitment of the talented professionals and the riches. In case of instability of the society, these people are

usually the first to move away.

Before June 4, not many people concerned about the right to abode in overseas countries. People did not care very much about this issue because they have confidence in Hong Kong after 1997. "Fifty years unchange for policy in Hong Kong" is what the Hong Kong residents have been promised. After June 4, however, such confidence vanished. People who can afford to emigrate began to look for passports so that in case there are any changes in Hong Kong after 1997, they can leave immediately.

After June 4, Singapore is the first country which offers residentship for Hong Kong citizens. Following Singapore, many countries, including Canada, New Zealand and South African, also considered relaxing immigration restrictions for Hong Kong residents. Even firms which faced acute loss of employees due to brain drain considered providing emigration assistance programmes for their middle to senior executives by way of transfers to other offices outside Hong Kong. This is popular for multinational companies with offices in the United States, Australia, Canada or France.

British Government later also agreed to grant 225,000 citizens in Hong Kong the right of abode in British. Though this number is far from adequate, the scheme can still act as an insurance policy and will contribute towards reducing the brain drain which threatens to undermine confidence in the territory. Of course, all these are highly welcome by Hong Kong residents but some pointed out, however, that the nationality package for only 50,000 Hong Kong households would cause divisions and jealousy among Hong Kong people.

What effects would be posed by the nationality package to Hong Kong after 1997 is too early to say because it may not even get pass the Parliament. One problem which is likely to occur is that in case situation in Hong Kong turns worse and the economy suffers a slump after 1997, those people with overseas passports may choose to quit Hong Kong, making the situation in Hong Kong even worse. No commitment to the territory is the rationale against not offering nationality package to Hong Kong people.

China is suspicious of Britain's intent behind its right of abode offer for Hong Kong and complained that the package was aimed at turning all key

personnel in Hong Kong into Britain subjects, or to extend British authority in the territory after 1997. As for maintaining and preserving its economic prosperity and social stability in Hong Kong up to 30 June 1997, Chinese leaders do not deem the scheme necessary for Hong Kong. As a matter of fact, they were afraid the scheme would be counter-productive. Giving the right to abode to Hong Kong citizens means dragging people away or accelerating people's motives to go, China thinks.

This is also why the China authority constantly criticized the nationality package for causing confusion and undermining the stability of the territory. They threatened not to recognize the status of those Hong Kong residents who will benefit from the special nationality package granted by Britain and will do anything they can to stop the implementation of the scheme.

China also said they already had made many concessions, including more directly-elected seats to the Legislative Council, to Hong Kong and the people of the territory should reciprocate by putting trust in the Beijing Government.

Labour Shortage

The term brain drain and labour shortage are similar except the latter usually refers to a broader base, i.e. lack of skilled and unskilled labour for all sectors in a society.

There are two common ways to overcome labour shortage. One is rectified through greater capital investment. The other is to transfer production to less developed countries where cheap labour is readily available.

Hong Kong has seen its labour force dropped from about five per cent in 1970s to 1.5% in 1988. At the same time, real wages have been rising and labour productivity in the manufacturing sector has been decreasing. But because of the tight supply of labour, some sectors of the economy will have to grapple with high staff turnover and recruitment difficulties. In such circumstances, wage increases would be sustained at a high rate and remain a major source of inflationary pressure. As more people start to immigrate, labour shortage and inflation is expected to remain at a high level.

As for combating labour shortage in Hong Kong, most manufacturer of

low valued goods in Hong Kong choose to shift production plants to lower labour cost centres in Thailand, Malaysia, Indonesia and China.

Suggestions to put forward to ease the management supply, including the attraction of more expatriate managers, encouraging emigrants to return and importing managers from the mainland.

The most pragmatic answer is for the business of Hong Kong to have very practical programmes to strain and promote younger managers - people who are willing to stay in Hong Kong and commit to its future.

Industrial Relations

Industrial relations in Hong Kong for the past decade was pretty stable until last year when several large scale protest broke out. Nurses strike for better pay and use work-to-rule as their strategy. CMB drivers refused to drive before 10:00 a.m. on 29 Nov. 1989 followed by KCB drivers' four hours sit-in protest on 4 Apr. 1990 are both aimed at putting pressure to their employers for better compensation. Even civil servants like firemen launched a sit-in protest and hunger strike to fight for shorter work hour. Policemen's morale are also deteriorating due to their lack of work force and the pressure put on by the Vietnamese boat people.

The main rationale behind the discontent of employees are labour shortage and higher inflation. Labour shortage causes extra-work for other employees and high inflation caused their living standard to diminish.

The rapid deterioration of the morale of civil servants and the quality of services offered is expected to be the major difficulties facing the territory over the coming few years. But how this will be affected by the 1997 issue will be surveyed in this research.

Social Demonstration

Demonstration is a way of showing discontent for living standard, unfair treatment, government policy... etc. Demonstration can be in form of public meeting and procession. The number of demonstration in a region is a good indicator of the degree of dissatisfaction of local citizens and a sign of social

unrest. According to government records, police received 297 applications for public meeting and another 290 for processions in 1989. The number is a drastic change of more than six times the statistics for 1984, when only 38 requests for public assemblies and 31 for mass processions were filed.

| Applications | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|-----------------|------|------|------|------|------|------|
| Public Meetings | 38 | 108 | 82 | 92 | 176 | 297 |
| Disallowed | 1 | 2 | 1 | 3 | 3 | 2 |
| Processions | 31 | 83 | 169 | 172 | 199 | 290 |
| Disallowed | 4 | 1 | 4 | 2 | 5 | 3 |

Source: SCMP, 14 April, 1990

Figure 7. Number of Demonstrations in Hong Kong.

Demonstration in form of public meeting and procession by nature would not cause harm to the society and, in fact, can be a means of getting rid of discontent. However, in a situation when the crowd is very concerned, angry or volatile, or when counter-demonstration is likely to occur, then the protests may turn into violence or riot. Another consequence, which may has a more direct impact on business in Hong Kong, is when demonstration developed into the form of large scale strike in order to put more pressure on the government.

Fortunately, much of the protests in the past years were caused by discontent towards the policies of mainland China rather than local government, especially after the June 4 incident. It is anticipated that the number of demonstrations will continue to increase, mainly for the purpose of urging more democratic reform in China and more autonomy for Hong Kong as 1997 draw closer. Whether it will continue to increase beyond 1997 will be researched in our survey.

Riot

Reasons for occurrence of riot are similar to demonstration except that they are displayed in more volatile and violent ways. Fortunately, riot in Hong Kong is extremely rare in the past, maybe due to the fact that Hong Kong

citizens are obedient by nature, or that they are not yet discontented or dissatisfied to the extend to cause riots. It is definitely sure, however, that the more riots means more social unrest and would cause disturbance in the Hong Kong economy ultimately.

Government Structure

Government structure can be classified into different types according to their tendency for radical political change, with democratic systems given a low probability for this occurrence and newly independent states a high one.

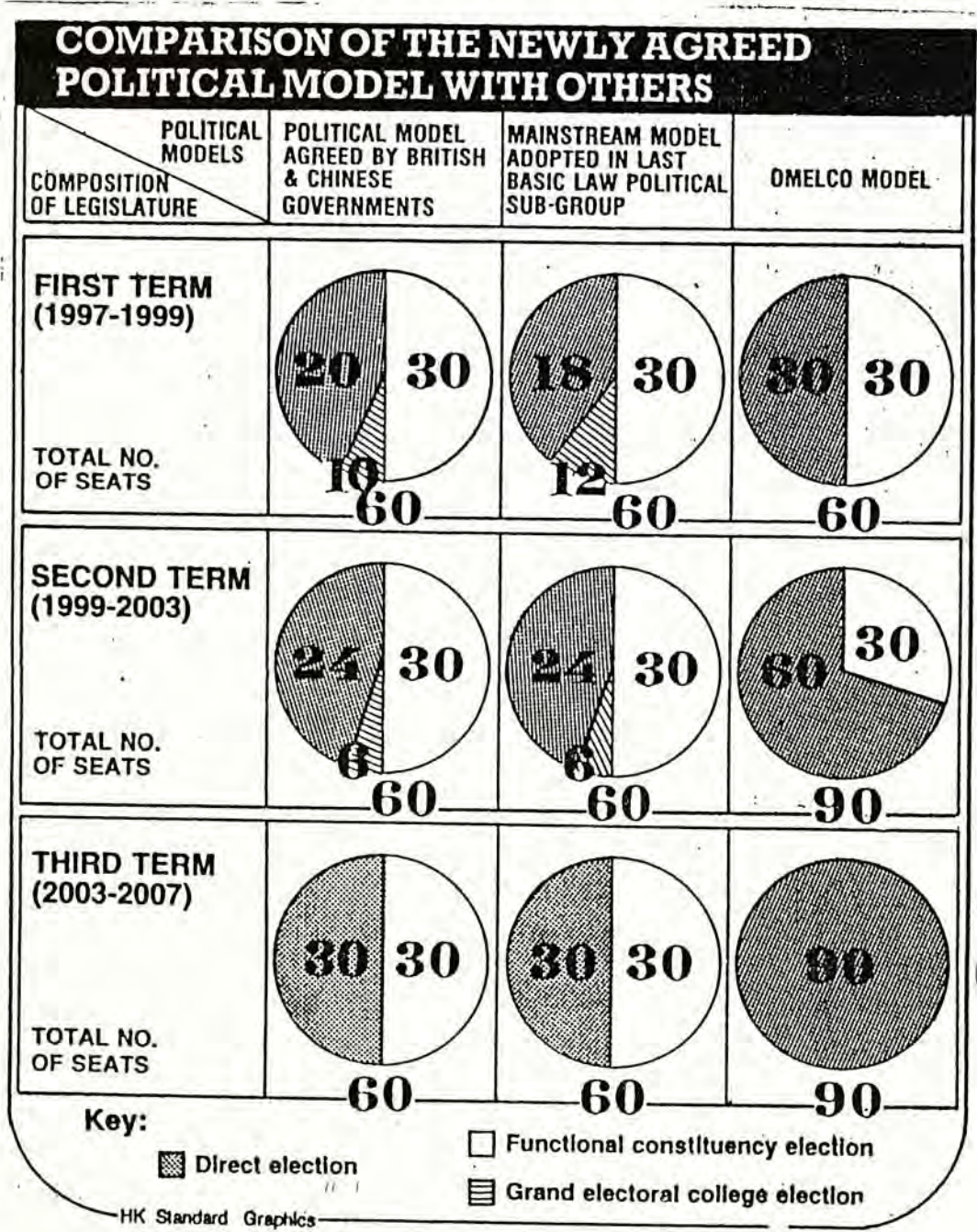


Figure 8. Comparison of the newly agreed political model with others.

A convergence of political systems before and after the 1997 handover was secured after Beijing and London ironed out their differences over the pace of democratisation for the territory. The final version of Hong Kong's future constitution was endorsed by the Basic law drafters at the mid Feb, 1990. Hong Kong government announced that it would raise the planned 10 directly-elected seats for the 1991 polls to 18. The number will be increased to not less than 20 in 1995. A comparison of the newly agreed political model with others on or beyond 1997 is diagrammed Figure 8.

Relations with China

The past decade saw a very stable and close relation between China and Hong Kong, especially when there is a huge amount of capital investment flow into China via Hong Kong. China and Hong Kong are in a position that is mutually benefit.

The June 4 incident is a turning point for this relation. After June 4, people become uncertain about the policy in Hong Kong after 1997 and began to fight for more autonomy for the territory. China, in turn, accused Hong Kong as being a subversive plant.

The Yang Yang Incident further weakened the relationship between Hong Kong and China who revenged by not taking back illegal Chinese immigrants.

The nationality package for Hong Kong residents is another issue that China doesn't feel quite happy. Although most of these problems are solved, relationship between China is still a very important subject that mustn't be neglected.

Relations with Foreign Countries

Hong Kong has been trying to be neutral in dealing with foreign countries and as a result its relations with foreign countries is very good. As far as we can recall, there seems no countries particularly that Hong Kong voted not to deal with. Even for China and Taiwan, whose policies are against each other are both good with Hong Kong at the same time.

We will learn whether such good relations with foreign countries could maintain after 1997 according to the executives' point of view.

CHAPTER IV

METHODOLOGY

Research Design

This is a descriptive study targets at illuminating the attitudes of business executives towards the political risk for business in Hong Kong. The survey was conducted by using semi-structured, undisguised questionnaires of which each questionnaire would be mailed to the designated respondent with an accompanying cover letter. The respondents completed the questionnaire at their leisure and mailed their replies back to us. By analyzing the results of this survey, a tentative picture can be built up for various executives' opinions, the types of problems faced, and the strategies to avoid exposure to political risk.

The target population for this study were the business organizations which were listed in the "Dun's Market Guide to Hong Kong Business 1988". They include both the local and the foreign companies. In order to secure meaningful data, only companies that have the strength and resources to consider the importance of political risk were used for sampling. It was arbitrarily assumed that they were companies with 50 or more employees. Company heads such as the managing directors or general managers were usually the most influential people in any decision making. They were chosen to respond for the opinions of their companies.

Data Collection Method

Secondary Data

At the outset of the study, it was intended to collect relevant data concerning the political risk for business in Hong Kong. Secondary data which is useful to us include the published external secondary data and data supplied by commercial marketing information services.

"ABI INFORM" was an on-line computer search which was useful for locating published information and data in the last five years. The researcher can use on-line data base to search for journal articles according to their own needs. Additionally, exploratory insights into the problem could also easily be gained by reviewing the current issues on the newspapers.

"Dun's Market Guide to Hong Kong Business 1988" is a roster of about 20,000 companies. The address, number of employees, respondents, and descriptions of the business organizations are arranged alphabetically according to the companies' names. It allows the marketing researchers to access the information on a company-by-company basis. The "Hong Kong Monthly Digest of Statistics" also offers us great help in which it gathers the key economic data encompassing different industries.

Primary Data

The primary data was collected through mail questionnaires during which a semi-structured, undisguised questionnaire was used. There were reasons for choosing "mail" as the method of administration. First, it did not cost much, and it was sometimes the only way of contacting the relevant population, such as managing director who will not sit still for an arranged personal or telephone interview but may respond to a mail questionnaire. Second, it permits control of the bias caused by the interviewer-interviewee interaction. Respondents were also able to work at their own pace and produced better-thought-out responses.

However, there are several disadvantages. Mail questionnaires afford the researcher little control in securing a response from the intended respondent. It also affords little speed control, and thus it will involve a time lapse of several weeks for the questionnaires to reach the respondents, be completed, and find their way back.

One has to contend with busy managing directors who have better things to do with their time than answer questionnaires. However, it was the fact that our attitude surveys produced low response rates i.e. 10%. Therefore, DELPHI TECHNIQUE was then used in which each business expert, acting separately, answer the questionnaire in a systematic, independent, and repeated manner

until consensus was reached.

Sampling Design

Sampling Procedures

The target population for this study was the business organizations which resided in Hong Kong. "Dun's Market Guide to Hong Kong Business 1988" is the sampling frame. This is an appropriate sampling frame in which it contains an accurate listing of both the local and foreign companies, although some of them are omitted and unlisted. In this research, a non-probability, judgement sample is used, and experts from different companies are selected as the sample elements. Since they are the representatives of our population of interests, they will be treated to the indepth political risk analysis.

Sample Size

In our experts' opinion poll, six experts are purposely identified and selected, of whom they represent professionals from companies of different industries. They are chosen not only because they are the representatives but also they offer some insight and perspective on the research questions as well.

Sampling and Nonsampling Errors

Nonprobability samples involve personal judgement somewhere in the selection process. In this research, the fact that the elements are not selected randomly precludes an assessment of "sampling errors".

Nonsampling errors may arise because of errors in conception, logic, analysis, data gathering, and so forth. The major category of nonsampling in our survey is errors of nonobservation. It can, in turn, be divided into noncoverage errors and nonresponse errors.

Noncoverage is a problem in our mail questionnaires. The business directory dictates the sampling frame. Since the directory may not adequately represents segments of the population, the survey will then suffer from the bias of noncoverage due to the fact that the directory can not exactly capture the population that we wish to study.

Nonresponse error represents a failure to obtain information from some elements of the population that were selected and designated from the sample. It arises because the designated respondents (i.e. managing directors) refused to participate. However, our research is utilizing the Delphi Technique of experts' opinion poll. The response rate is 100%, and thus a systematic bias is excluded.

Data Analysis

The data collected in the questionnaires were used for the following analysis:

1. Attitude Measurement

A "snake" diagram is plotted in which it shows a contrasting profile for the respondents' opinions on the riskiness of different political situations before and after 1997.

2. Frequency distribution of

The respondents opinions on the major political risk avoidance taken by their companies.

Questionnaire Design

The complete questionnaire was divided into six parts:

(1) The growing interdependence of political, social and economic environment continue to present serious problems for both the local and foreign enterprises in Hong Kong, the first question here will examine the attitudes of the experts towards the political risk for business in Hong Kong before and after 1997.

Attitude usually connotes a preference regarding the positive-neutral-negative feelings for the object. In this attitude survey, respondents were given a interval scale of numbers from 1 to 5 which denoted the favouritism of the political risk factors toward their business. They were asked to answer descriptively according to their own perception. All the risk factors were identified from the Jeffery D. Simon's political risk framework and meanwhile they were influencing Hong Kong's political destiny as well.

All political risk factors are classified into three categories for risk assessment as shown in the following table.

| ECONOMIC RISK | <u>SOCIAL RISK</u> | <u>GOVERNMENTAL RISK</u> |
|-------------------------|----------------------------------|--|
| Economic stability | Industrial Relation | Restriction on capital/profit repatriation |
| Exchange rate stability | Social demonstrations | Changes of political leaders |
| Currency convertibility | Riots | Government structure |
| Stability of prices | Relations with China | |
| Economic recession | Relations with foreign countries | |
| Labour productivity | | |
| Brain drain | | |
| Labour shortage | | |

Figure 9. Risk Factors Classification

- (2) The second question deals with the demographic characteristics of the companies.
- (3) The third question asks about the respondents opinions about the three major political risk factors which might affect their business before and after 1997.
- (4) The fourth question inquires about the rating of the overall risk for business before and after 1997 as perceived by the respondents.
- (5) The fifth question asks the respondents' opinions about the most appropriate risk avoidance policies for their business in Hong Kong.
- (6) The sixth question asks the respondents if they can suggest any additional risk avoidance policies for their corporation.

CHAPTER V

RESULTS AND ANALYSIS

In the expert opinion poll, Delphi Technique was used in which each of the six individual experts, acting separately, pool their opinion in a systematic and repeated manner until consensus was reached. Initially, the experts are asked separately to grade a scale of 1 to 5 over identified elements concerning the political issues in Hong Kong. The scale 1 stands for the least favourable whereas scale 5 implies most favourable. After the results had been collected and compiled, each expert was received a copy of the results and was asked for their solutions again. We executed the opinion three times and finally the consensus has been reached. The results are tabulated in Figure 10 and analyzed as follows:

Economic Stability

From the experts' view points, Hong Kong economic stability will remain fairly favourable (3.83) as 1997 is approaching but become less favourable (2.75) afterwards. It may be due to the fact that some people are worrying the Chinese government may install a tighter control of the economic policies for Hong Kong after 1997. It gives rise to the problems such as high inflationary rate, external debt levels or shortage in supplies and it in turn induces economic instability.

Exchange Rate Stability

The respondents believe that the exchange rate is highly favourable (4.67) as 1997 is approaching, but becomes less so (3.00) after 1997. This indicates that some executives do not have confidence on exchange rate stability after the sovereignty of Hong Kong returned to China.

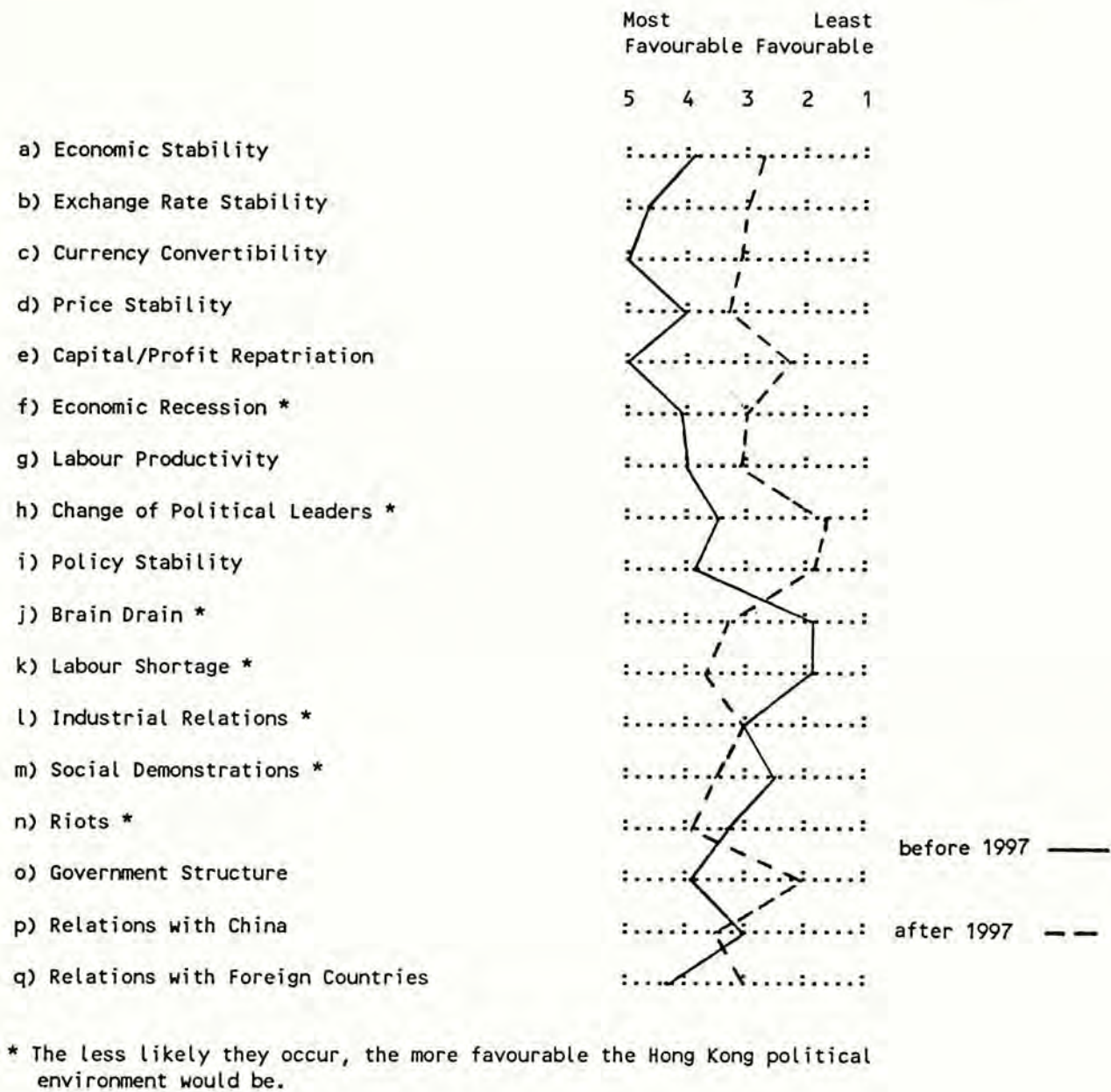


Figure 10. The Expert Opinion Poll by using Delphi Technique.

Currency Convertibility

According to the experts' points of view, currency convertibility is in an excellent position (5.00) before 1997, but will become fairly favourable (3.17) afterwards. When people do not have confidence in the territory (i.e. Hong Kong), less people will be willing to hold Hong Kong Dollars, which in term means convertibility decreased.

Price Stability

The average prices paid by consumers has risen through most of our

recent history. Actually, a small rate of inflation make it easier for the economy to adjust to changes and to maintain a high level of employment. Since the inflationary pressures were largely domestically generated, government expects inflation to stay high, with the indication from the trend of the Consumer Price Index.

From the experts' sight, the transition of 1997 causes the downfall of price stability (i.e. from 4.00 to 3.33) but still remains in a favourable situation. Some people worry that the Chinese government may restore to tighter control of the economy or even return to the old central planning system. The government economists believe in the possibility of the fluctuations of the prices. However, they expect inflation to ease as domestic demand slows down and the world commodity prices soften.

Restriction on Capital/ Profit Repatriation

Another powerful tool at the disposal of foreign governments is the imposition of restrictions on the repatriation of profits and capital. In certain instances, this strategy is used when internal disorders and apprehension concerning the future lead to a sudden outflow of foreign capital.

Respondents believe that capital or profit repatriation is achieving an excellent position (5.00), i.e. owners of foreign firms are absolutely free to retreat with their capital profit from the territory before 1997, but the condition will become fairly unfavourable (2.25) after the handover of Hong Kong to China. Hong Kong is the third largest financial service centre in the world. Foreign-exchange balance is controlled in a free market. Even in the times of political uncertainty - such as the period following the Tiananmen Square Incident - capital outflows freely as emigration increases and business confidence falls. The survey illustrates that the confidence of the business people will greatly drop after 1997. This may be due to the fact that Chinese government is fond of the practice of trial and error, many of the regulations for capital or profit repatriation are subjected to environment change and amendment. Therefore, the investors confidence is still a long way to recover and current tension do exist.

Economic Recession

The respondents view that the economic recession is rather unlikely (4.17) before the transition of 1997, but may become fairly likely (3.00) after 1997. Hong Kong has an extremely resilient economy and in an overhead position for a few years. However, after the transition of 1997, the demands for goods and services may fall off, the opportunity for greater output, greater efficiencies and greater productivity are less. These are the possible reasons why the respondents felt that the economy is going to be worse off.

Labour Productivity

The experts feel that the labour productivity is highly favourable (4.00) before 1997 but becomes less so (3.17) after 1997. Since Hong Kong has faced the capacity labour shortage problems for a long time, it can be solved by exploiting the potential of South East Asian countries. By transferring its manufacturing base lower-cost centres in Thailand, Malaysia, Indonesia and China would be an appropriate solution. Since, the labour productivity there are low compared with Hong Kong, the experts foresee the drop in labour productivity after 1997.

However, our research group holds an added view in regard to the previous mentioned experts' opinions. An improvement in the technology, quality (i.e. education) of the labour force, methods of production and allocation of resources can also give rise to the increase in labour productivity. Additionally, some economists forecast that the ambitious port and airport development projects would boost productivity too.

Change of Political Leaders

1997 comes to Hong Kong with the turnover of the sovereignty to mainland China, and it brings over the change of policies as well as the political leaders. In our survey, our experts perceive that the change of political leaders may still keep the business environment in a fairly favourable position (3.56) before 1997 but will become highly unfavourable (1.67) afterwards.

Today, the Hong Kong Legislative Council consists mainly the conservatives and liberals. Some are also the committees who made the major

concessions in the Basic Final Draft. People argue that the final blueprint was one that satisfied no one. Who can lead Hong Kong's future? Who will the political leaders head the Special Administration Region (SAR) in 1997? Martin Lee, Vincent Lo or other Chinese high-ranking officials who prefer a slower pace of reform. It is still in the guessing game. Some investors are worrying that there may be a change of the chief officials in China, which, in turn, affects the existing policies in Hong Kong. Some respondents may view that the change of chief government officials poses the biggest political threat to them. As a citizen of Hong Kong, we are looking forward to some thoughtful, perceptive men and women to lead the territory when the 1997 transition moment comes.

Policy Stability

This is a risk that affects the operations of an investment most directly. It is no doubt that Hong Kong's policies are highly stable (3.83) under the rules of the British Government. This is the general view hold by the respondents too. After the sovereignty of Hong Kong is returned to China, respondents believed that the policy stability will become highly unstable (1.83). Before the June 4 Incident, the Chinese Government had been adopting an open door policy, and Hong Kong people were generally optimistic about the future political environment of China. After the June 4, the Beijing Government's brutal suppression of the student demonstration, has proved once again that China operates by its own set of rules and standards, which are inexplicable to the watching world. Ten years of winning confidence through its "open door" policies and economic reform have been wasted in one night of slaughter. It is no wonder why people are pessimistic about the policy stability under the "One Country, Two Rule System".

Brain Drain

According to SRH research conducted at Jun 1989, 17% of the respondents or their family members have already had residency right of some foreign countries. It is also proven by the respondents' opinions that before 1997, the brain drain problems would be very intense (1.83). However, they would believe such brain drain current will be stabilized (3.33) after 1997.

Recently, the British Government offers 225,000 full British passports to Hong Kong people in the hope of maintaining the stability of Hong Kong. More than half of the multinational companies with offices in U.S., Australia, Canada and France have provided emigration assistance programmes for their middle to senior executives. According to Mr. Andrew Tsui, managing director of executive search firm Russell Reynolds Associates, said if more country countries could offer the right of abode to Hong Kong executives without residency requirements, it would help to curb the worsening brain drain problem. Some companies now gives more attention to well-structured compensation schemes, training and development programmes and they will help to stabilize the brain drain current too.

Labour Shortage

Human Resources is the most important assets in the organizations. As the emigration current is intensifying, labour shortage becomes the hottest issue and hardest problem to solve throughout the manufacturing and service sectors in Hong Kong. The respondents believe that staff turnover and recruitment difficulties are going to be in a unfavourable condition (1.83) before 1997 but will become better off (3.61) afterwards.

As predicted by the economists, the territory may face the economic downturn after 1997 transition, and it implies the labour demand will not be as keen as before. In addition, greater capital investment, more attractive salary packages, and a transfer of production to less developed countries, these can also minimize the labour shortage problem in Hong Kong to a great extent.

Industrial Relations

Recently, civil servants such as firemen, dental surgeon assistants, court prosecutors, inoculators, midwives, nurses surveying officers and police superintendents are already leading the way in the fight for better pay and conditions. Some also have threatened industrial action if their grievances are not given prompt attention. The recent successful strike by China Motor Bus (CMB) drivers had great impact on civil servant unions, prompting them to be more ready for industrial action. In reality, the labour relations experts believed

that more confrontational industrial disputes in both the private and public sectors could appear in the coming year with the slowing down of Hong Kong's overall economy.

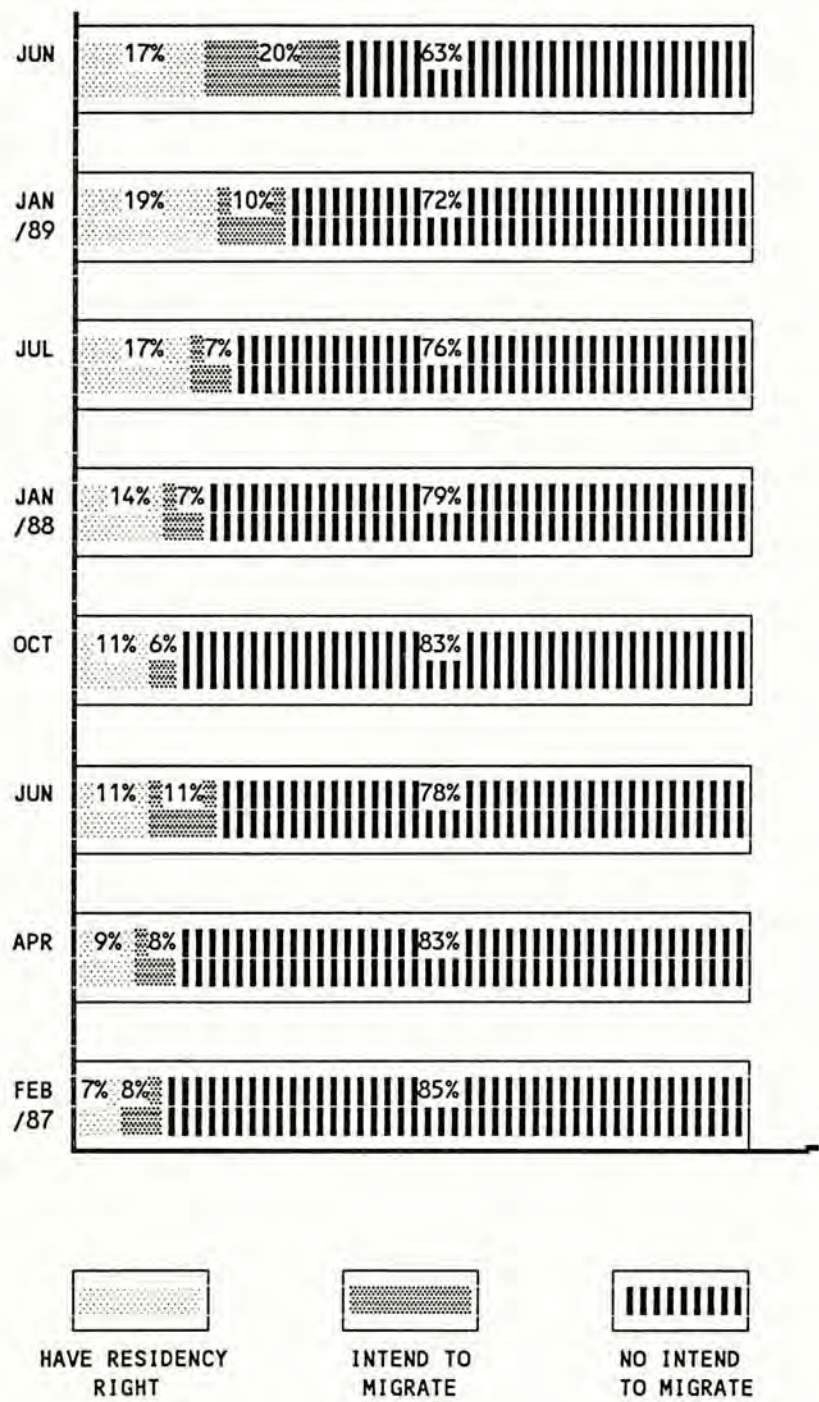


Figure 11. Households having Residency Right of a Foreign Country or Intend to migrate.

The respondents also foresee the industrial relation be less favourable (2.83) before 1997 and will be improved slightly (3.00) afterwards. As the sovereignty of Hong Kong returns to China, collective bargaining as a means to

settle industrial disputes between employers and employees might be more fully implemented. Therefore, there is no reason why the industrial relations should not be improved.

Social Demonstrations

This type of internal violence is the most publicized forms of societal related actions that can harm a large portion of both the local and foreign business sectors. In Hong Kong, quite a number of social demonstrations have been taken places during recent years.

The respondents view that social demonstrations are fairly likely to happen (2.5) but will be less likely to occur (3.5) after 1997. It means that the political risk for social unrest and disorder will be stabilized with the transition of 1997. This considerable improvement on the position may be due to the fact that the communist regime in Beijing would impose a tighter control of strikes and demonstrations for post 1997 Hong Kong. Moreover, the development of political parties also provides a focus and a forum for the organised expression of political views held sincerely by the like-minded people. Although political parties oppose each other, but it encourages Hong Kong people to channel their anger and grievances in a more positive direction.

Riots

Often times protests and demonstrations are served as a harbinger for more violent behaviour such as mass riots. Not many riots were found in Hong Kong last year. However, a small scale riot happened a few nights right after the June 4 Massacre had caused concern. A truck cruises on Nathan Road with its full complement of protesters. They come in commercial vans, cars and trucks. All have banners and posters stuck to their vehicles, and strips of black cloth tied to antennae. A few hundred youths marched and chanted slogans. But the anguish and poignance of former protest marches was not there, the discipline which marked the demonstration by day was absent either.

As viewed by the respondents, the mass riots are less likely (3.33) to occur and this political risk will be reduced (3.83) after the handover of Hong Kong's sovereignty to mainland China. The enormous outburst of emotion in the

territory, with anger and grief may be suppressed by the tighter control of the policies under the "one country, two systems" for post 1997 Hong Kong. And thus, the concerns for business interests from both the local and foreign investors will also be less threatened by mass riots as time passes by.

Government Structure

The respondents believed that the government structure is quite favourable (3.92) before 1997 but becomes less favourable (2.00) afterwards. In reality, a public opinion poll has found that the majority of people in Hong Kong are apathetic about the final draft of the Basic Law while fewer than 1% say they are very satisfied with the mini-constitution. Since the arguments over the democratic development after 1997 will largely depend upon China's democracy view over Hong Kong, most of our executives believed that China's pace will not be fast enough to allow Hong Kong to retain its economic success which is essential for corporate investment and growth. And therefore, respondents' views towards the threat posed by the government structure after 1997 and generally pessimistic.

Relations with China

Hong Kong is regarded by many companies as the gateway for gaining entry into the enormous Chinese market. It is also a major channel for goods to and from China. The impressive growth and continuous prosperity of Hong Kong in the past decade was largely attributable to the economic development and friendly relationship with China.

Although the Yang Yang's incidence and the disputes over Basic Law has created substantial confrontation (3.08), the respondents believed that there is a positive sign for improving the relations (3.50) after the handover of Hong Kong to China.

For most people in Hong Kong, the best hope is that the monstrous events in Beijing will precipitate the downfall of the discredited group of old men currently in control, and that a new leadership will emerge within the next few years who can be more reliable guarantors of Hong Kong's future. One other consolation: there are still seven years to repair the relationship.

Relations with Foreign Countries

The change in relationships of Hong Kong with foreign countries may affect the respondents' trading and other business activities. As viewed by the respondents, the relationship between Hong Kong and foreign countries were highly favourable (4.33) before 1997, but become fairly favourable (3.00) afterwards.

Nowadays, Hong Kong is slowly pulling itself out of the slump following the upheavals in China last year. After the handover of Hong Kong to China, some consultancy says deteriorating politics, higher inflation and infrastructure bottlenecks will be "scaring away the potential investors", although the investment climate remains generally attractive. Our respondents holds the same depressing view. However, Mr. Martin Barrow, the Chairman of Hong Kong Tourist Association, say the territory should therefore be promoted as an international, exciting and vibrant city in Asia. Perhaps, Hong Kong government should promptly step up its own activities through its overseas offices to improve its relations with the foreign countries.

| | | Developing | |
|------|----------|--|---|
| | | Internal | External |
| Open | Direct | Economic Stability Currency Convertibility Labour Shortage Labour Productivity | Economic Recession Illegal immigrants e.g. Vietnamese refugee and Chinese illegal immigrants. Quota and Tariff imposed by foreign countries |
| | Indirect | Brain Drain Social Demonstration to urge for more democracy. Price Stability, mainly inflation | Change of Political Leaders Relations with Foreign Countries, especially with China and U.S. |

Figure 12. Political Risk Factors in Hong Kong before 1997, based on Simon's (1984) model.

We can classified the risk factors with score equal to or below three, as identified by the experts, as the major political risk in Hong Kong. The tables in Figure 12 and 13 summarise such political risk as based on Simon’s four dimensions, for the period before and after 1997 respectively.

| | | Developing | |
|------|----------|--|---|
| | | Internal | External |
| Open | Direct | Economic Stability Currency Convertibility Labour Shortage Labour Productivity | Economic Recession Illegal immigrants e.g. Vietnamese refugee and Chinese illegal immigrants. |
| | Indirect | Brain Drain Social Demonstration Restriction on Capital/Profit Repatriation Price Stability, mainly inflation Government Structure, may have too much bueaureacy and red-tape Policy Stability | Change of Political Leaders in China and their Leadership struggle Deteriorating relations with in China and their power struggle Deteriorating relations with Foreign Countries. |

Figure 13. Political Risk Factors in Hong Kong after 1997, based on Simon’s (1984) model.

Risk Avoidance Strategies

The final task in assessing political risk is to devise strategies for diminishing a firm’s risk exposure. While there is little a company can do to ward off internal violence or political instability, there are a number of techniques it can employ to discourage expropriation. From the experts’ opinion survey, besides asking the respondents the types of political risk they are facing, we also ask their insight on the risk avoidance strategies. Their responses are graphed and the most popular few are discussed as follows:

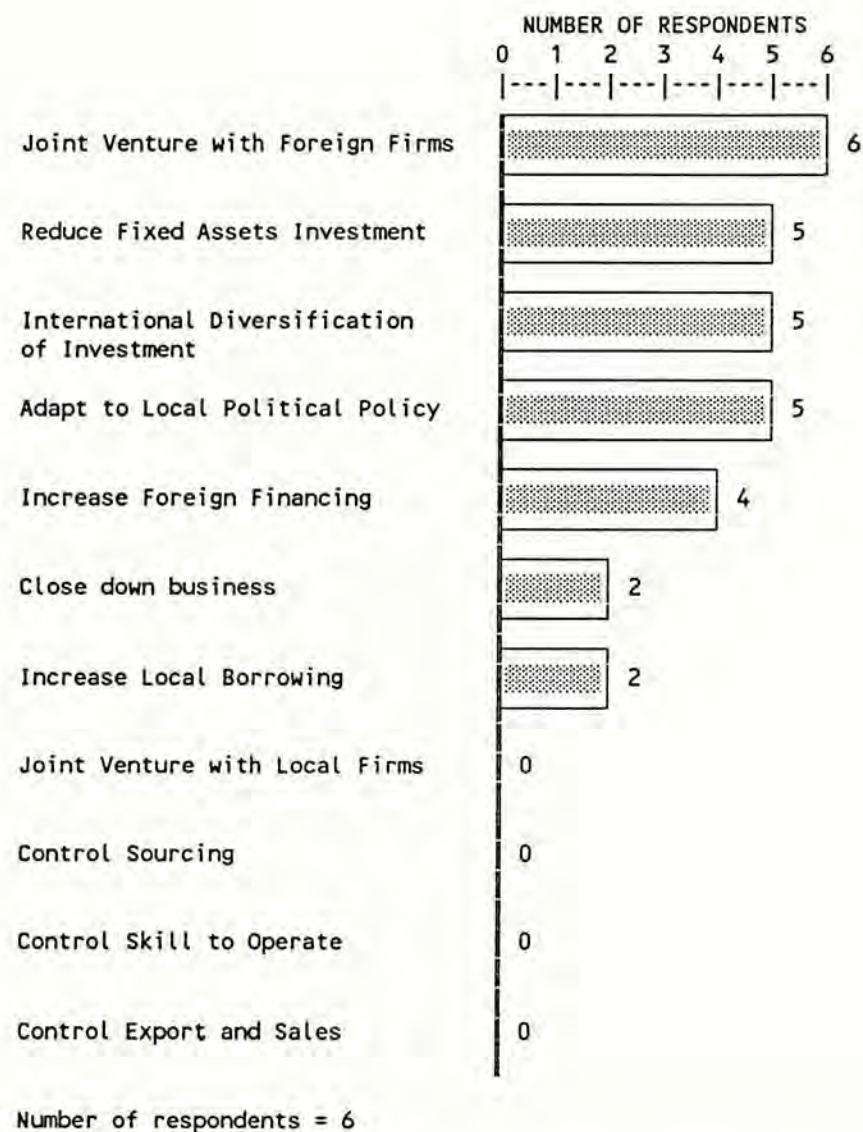


Figure 14. Risk Avoidance Policies from Expert's Opinion Poll.

Joint Venture with Foreign Firms

The first method of diversifying political risk can be through joint venture investment projects with foreign companies or nationals or to allow foreign country stockholders to participate in the financing. For instance, by allowing stockholders to own a sizable portions of the firms investment, say 40%, while retaining a controlling interest, the firm transfers a portion of the political risk to foreign countries' citizens.

International Diversification of Investment

Political risk can be minimized through international diversification of investment. Firms may choose to diversify the risks of their operations among

other multinationals. For example, manufacturing plant can be moved to other countries that possess similar comparative advantages as well as a strong host government that stands up to the protectionism sentiment of the developed countries.

Reduce Fixed Assets Investment

Political insurance is not available to Hong Kong investors. To cope with the political risk in Hong Kong, most of the respondents adopt an adaptive approach. With limited bargaining power, the small investors form Hong Kong vulnerable to environmental changes. However, they have their own protective measures. 83% of the respondents try to recover all their investments within three to five years to reduce their risk exposure. They can either reduce the fixed assets or finance more short term projects so that their investments are all recovered within short time. And therefore, any political changes in Hong Kong are unlikely to cause them great damages.

Adapt to Local Political Policy

Risk minimisation methods include keeping a close monitoring of the local political policies and evaluating its effects on the nature of the territory. Both of the local and foreign firms can do so to minimize the political risk.

Increase Foreign Financing

Last but the least, firms can diversify their risks by enhancing their political leverage. In the financing decision, for example, firms can seek broad international financing rather than relying on single country sources.

CHAPTER VI

DISCUSSION

Our survey find that the political risk in Hong Kong, from the businessmen's point of view, is not very substantial before 1997. Brain drain, industrial relations and social demonstration are the major political risk in the territory while other risks such as economic stability, restriction on capital/profit repatriation, government structure... etc are not likely to cause great trouble to the territory. After 1997, however, economic stability, restriction on capital/profit repatriation, policy stability and government structure may become substantial while brain drain, industrial relations and social demonstration are expected to improve. It is believed, therefore, Hong Kong's political risk environment will worse off after 1997 but the business experts also indicated that such depressed environment may be back to business as usual as time goes by.

Some optimistic businessmen believe that Hong Kong will continue to act as the headquarters for administrative, marketing, design and research and development operations as there is no better place in Asia than Hong Kong to do much of the support work for the manufacturing and trading sectors.

Nevertheless, it is generally believed that Hong Kong may become more difficult to govern as 1997 approaches. There is a danger of political turmoil if the Hong Kong government, acting under orders from London, refuses to establish a sufficient number of directly elected seats in the Legislative Council to satisfy popular demands for democracy.

The continuing brain drain lead to a breakdown of government services, such as schools and hospitals. Unemployment may mount as capital is withdrawn from Hong Kong enterprises and invested overseas.

There is the likelihood of inflation as employers bid up wages in order to attract the diminishing supply of professionals. There may be increasing

industrial militancy when workers go on strike for higher wages and better retirement benefits to protect themselves against a bleak economic future.

The frustrations of those who cannot leave may erupt into violent demonstrations and protests. If such a situation should arise, it is quite conceivable that the British Government would decide to cut its losses and terminate colonial rule without delay.

After 1997, it is expected that the territory will undergo a period of economic depression. Instead of being a regional head-quarter for the whole Asia, Hong Kong may be reduced to a service centre primarily for China and Taiwan only.

Foreign firms which already have investment in Hong Kong or are going to invest in the territory need to closely monitor the activities of the Chinese government and evaluate its effects on the future of Hong Kong. Diversification of risk can also be achieved by moving manufacturing plants to other countries that possess similar comparative advantage as well as a strong host government that stands up to the protectionism sentiment of the developed countries. To reduce the currency fluctuations, companies are advised to keep the trading in foreign currencies as much as possible.

Risk administration includes a constant review of the whole risk management programme including taking action to identify, assess and handle all potential areas of exposure. Decision should be made as to which risks need to be dealt with, and what level of risk retention is desirable. This is, of course, a continual process.

CHAPTER VII

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APPENDIX 1

QUESTIONNAIRE

(as attached)

QUESTIONNAIRE

(Note: Political Risk refers to all unwanted consequences adverse to business and is bought about by political sources or environment.)

(1) Please access the following situations for business in Hong Kong **BEFORE** and **AFTER** 1997.

| | Most Favourable | | Least Favourable | |
|---|--------------------|---|---------------------|---|
| a) Economic stability (Before 1997) | 5 | 4 | 3 | 2 |
| (After 1997) | 5 | 4 | 3 | 2 |
| b) Exchange rate stability | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| c) Currency convertibility | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| d) Stability of price | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| e) Restriction on capital/profit repatriation | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| f) Economic recession | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| g) Labour productivity | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| h) Change of political leaders in China | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| i) Policy stability | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| j) Brain Drain | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| k) Labour Shortage | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| l) Industrial relations (relationship between employers & employees) | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| m) Social demonstrations | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| n) Riots | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| o) Government structure | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| p) Relations with China | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |
| q) Relations with foreign countries | 5 | 4 | 3 | 2 |
| | 5 | 4 | 3 | 2 |

DEMOGRAPHIC

(2) Please indicate the attributes of your current company?

- a) Nationality of your company

b) Industry

c) Number of employees

d) Number of years it has been started
-

(3) From your opinion, what are the major political risks for business in Hong Kong?
(Please specify in order of importance)

- Before 1997
- After 1997

(4) How would you rate the overall political risk for business in Hong Kong for the near future?

| | Most Favourable | | | Least Favourable | |
|-------------|-----------------|---|---|------------------|---|
| Before 1997 | 5 | 4 | 3 | 2 | 1 |
| After 1997 | 5 | 4 | 3 | 2 | 1 |

(5) What are the most appropriate risk avoidance policies to reduce political risks for business in Hong Kong? (Please check whenever appropriate)

- Close down business

Reduce fixed assets investment in Hong Kong

Increase local borrowing

Increase foreign financing

Joint venture with foreign firms

Joint venture with local firms

International diversification of investment

Control sourcing

Control skill to operate

Control export and sales

Adapt to local political policy
-

(6) Could you suggest any other risk avoidance policies for your corporation?

THANK YOU FOR YOUR KIND ASSISTANCE !

APPENDIX 2

POLITICAL RISK FACTORS FROM EXPERT OPINION

| SITUATIONS | TIME SPAN | FIRST INTERVIEW | SECOND INTERVIEW | THIRD INTERVIEW | FINAL RESULT |
|---|-------------|-----------------|------------------|-----------------|--------------|
| Economic Stability | Before 1997 | 4.08 | 3.83 | - | 3.83 |
| | After 1997 | 2.62 | 2.75 | - | 2.75 |
| Exchange Rate Stability | Before 1997 | 4.67 | - | - | 4.67 |
| | After 1997 | 2.83 | 3.00 | - | 3.00 |
| Currency Convertibility | Before 1997 | 5.00 | - | - | 5.00 |
| | After 1997 | 3.00 | 3.17 | - | 3.17 |
| Price Stability | Before 1997 | 4.00 | - | - | 4.00 |
| | After 1997 | 3.50 | 3.33 | - | 3.33 |
| Restriction on Capital /Profit Repatriation | Before 1997 | 5.00 | - | - | 5.00 |
| | After 1997 | 2.33 | 2.50 | 2.25 | 2.25 |
| Economic Recession * | Before 1997 | 3.67 | 4.00 | 4.17 | 4.17 |
| | After 1997 | 3.17 | 3.17 | 3.00 | 3.00 |
| Labour Productivity | Before 1997 | 4.17 | 4.00 | - | 4.00 |
| | After 1997 | 3.17 | - | - | 3.17 |
| Change of Political Leaders * | Before 1997 | 3.67 | 3.50 | - | 3.50 |
| | After 1997 | 1.67 | - | - | 1.67 |
| Policy Stability | Before 1997 | 3.83 | 4.00 | 3.83 | 3.83 |
| | After 1997 | 1.83 | - | - | 1.83 |
| Brain Drain * | Before 1997 | 1.67 | 1.83 | - | 1.83 |
| | After 1997 | 3.50 | 3.17 | 3.33 | 3.33 |
| Labour Shortage * | Before 1997 | 1.83 | - | - | 1.83 |
| | After 1997 | 3.67 | 3.50 | 3.67 | 3.67 |
| Industrial Relations * | Before 1997 | 3.00 | 3.00 | 2.83 | 2.83 |
| | After 1997 | 3.17 | 3.17 | 3.00 | 3.00 |
| Social demonstrations * | Before 1997 | 2.67 | 2.52 | 2.50 | 2.50 |
| | After 1997 | 3.50 | 3.48 | 3.50 | 3.50 |
| Riots * | Before 1997 | 3.17 | 3.33 | - | 3.33 |
| | After 1997 | 3.67 | 3.83 | - | 3.83 |
| Government Structure | Before 1997 | 3.83 | 3.92 | - | 3.92 |
| | After 1997 | 2.00 | - | - | 2.00 |
| Relations with China | Before 1997 | 3.17 | 3.08 | - | 3.08 |
| | After 1997 | 3.50 | - | - | 3.50 |
| Relations with Foreign Countries | Before 1997 | 4.33 | - | - | 4.33 |
| | After 1997 | 3.00 | 2.83 | - | 2.83 |

* The less likely they occur, the more favourable the Hong Kong business would be.

- Unchange

APPENDIX 3

RISK AVOIDANCE POLICES FROM EXPORT OPINION

| SUGGESTED POLICIES | FREQUENCY | | |
|---|-----------------|------------------|-----------------|
| | First Interview | Second Interview | Third Interview |
| Close down business | 1 | 2 | 2 |
| Reduce Fixed Assets Investment | 4 | 5 | 5 |
| Increase Local Borrowing | 1 | 2 | 2 |
| Increase Foreign Financing | 3 | 4 | 4 |
| Joint Venture with Foreign Firms | 6 | 6 | 6 |
| Joint Venture with Local Firms | 1 | 0 | 0 |
| International Diversification of Investment | 4 | 5 | 5 |
| Control Sourcing | 1 | 0 | 0 |
| Control Skill to Operate | 1 | 0 | 0 |
| Control Export and Sales | 1 | 0 | 0 |
| Adapt to Local Political Policy | 4 | 5 | 5 |

Number of respondents = 6

Rate of Response = 10%

APPENDIX 4

HOUSEHOLDS HAVING RESIDENCY RIGHT OF A FOREIGN COUNTRY
OR
INTEND TO MIGRATE

(by sex, age, education, household income and occupation)

| | Total % | Sex | | Age | | | Education | | Household Income | | | Occupation |
|--|------------|--------|--------|------------|------------|----------|-------------------|-------------------|-----------------------|-------------------------|----------------------|-----------------------------|
| | | M % | F % | 15-24 % | 25-39 % | 40+ % | Prim or < % | Seco or > % | Under \$5,000 % | \$5,000 \$7,499 % | \$7,500 or < % | Prof/Exec/ Pro/Trad % |
| Respondent or his/her family members having residency right of a foreign country | 17 | 14 | 20 | 14 | 20 | 16 | 12 | 19 | 14 | 13 | 19 | 30 |
| No residency right, but respondent or his/her family members intend to migrate | 20 | 23 | 17 | 23 | 23 | 14 | 12 | 24 | 13 | 13 | 24 | 34 |
| No residency right of a foreign country & no plan to migrate | 63 | 63 | 63 | 63 | 57 | 69 | 75 | 57 | 73 | 73 | 57 | 35 |
| Base | 3857 | 1998 | 185 | 941 | 1612 | 1306 | 1152 | 2701 | 413 | 802 | 2482 | 385 |
| Unweighed | 1109 | 623 | 486 | 264 | 489 | 356 | 293 | 815 | 109 | 210 | 744 | 185 |

APPENDIX 5

**ECONOMIC GROWTH
FOR ASIAN COUNTRIES
IN 1988 & 1989**

| COUNTRY GROWTH | GDP | | Inflation | |
|-----------------------|------|------|-----------|------|
| | 1988 | 1989 | 1988 | 1989 |
| NICs | 9.4 | 6.2 | 4.8 | 5.8 |
| Hong Kong | 7.3 | 2.5 | 7.5 | 10.0 |
| South Korea | 11.3 | 5.9 | 6.9 | 5.6 |
| Singapore | 11.0 | 9.2 | 1.5 | 2.8 |
| Taiwan | 7.3 | 7.7 | 1.3 | 4.7 |
| Southeast Asia | 8.0 | 7.7 | 5.1 | 6.1 |
| Indonesia | 5.7 | 6.5 | 4.9 | 6.0 |
| Loaos | 2.1 | 4.0 | 33.0 | 60.0 |
| Malaysia | 8.8 | 7.6 | 2.5 | 2.8 |
| Philippines | 6.2 | 6.0 | 10.1 | 9.6 |
| Thailand | 12.0 | 10.8 | 3.7 | 5.8 |
| Vietnam | 5.8 | 3.2 | 492.0 | 35.0 |
| South Asia | 8.5 | 4.4 | 9.4 | 11.8 |
| Bangladesh | 2.7 | 2.4 | 9.4 | 8.0 |
| India | 9.5 | 4.5 | 9.1 | 10.0 |
| Maldives | 8.7 | 9.3 | - | - |
| Burma | 0.2 | 3.4 | 16.9 | 70.0 |
| Nepal | 9.7 | 1.5 | 9.1 | 10.1 |
| Pakistan | 7.0 | 5.6 | 8.8 | 10.4 |
| Sri Lanka | 2.8 | 2.0 | 14.0 | 11.6 |
| China | 11.2 | 3.9 | 20.7 | 18.0 |

Source: SCMP, April 24, 1990

APPENDIX 6

POLITICAL RISK FRAMEWORK BY SIMON (1984)

| | | Industrialized | |
|------|----------|--|--|
| | | Internal | External |
| Open | Direct | Host government licensing, price controls, taxation Adverse legal rulings Negative media reports | Home government licensing, taxation policies Regional and global organizations' monitoring of MNE operations |
| | Indirect | Bureaucratic delays and procedures Elections, public pressure for environmental controls Local business pressure for subsidies, favourable treatment | Host-home country trade disputes Bilateral/multilateral trade agreements detrimental to MNE Global economic developments |

(a) Industrial and Open.

| | | Developing | |
|------|----------|---|---|
| | | Internal | External |
| Open | Direct | Local content rules, joint venture pressure, technology transfer an import/export regulations Strikes, protests, boycotts, Adverse legal rulings Negative media reports | Home government licensing, taxation policies Regional and global organizations' code of conduct for MNE |
| | Indirect | Intra-governmental friction General strikes, elections Local business pressure for subsidies, favour tax rates | North-South issue disputes Anti-MNE public sentiment due to home country's foreign/ military policy Regional/border wars High external debt, default Commodity price fluctuations |

(b) Developing and Open

| | | Industrialized | |
|-------|----------|--|---|
| | | Internal | External |
| Close | Direct | Restrictions on remittances Strikes, terrorism, violent demonstrations/protests | Home government restrictions on operations Negative home and international public opinion, disinvestment pressure |
| | Indirect | Coups, radical regime change, leadership struggles Revolution, guerrilla war, riots | Deteriorating host-home relations International economic sanctions/boycott International protests Global economic developments |

(c) Framework for Industrial-Close Country

| | | Development | |
|-------|----------|--|--|
| | | Internal | External |
| Close | Direct | Nationalization, expropriation Terrorism, riots, strikes | Home government restrictions on operations Negative home and international public opinion, disinvestment pressure |
| | Indirect | Coups, radical regime change, leadership struggles Revolution, guerrilla war, riots | North-South issue disputes Anti-MNE public sentiment due to home country's foreign/military policy Regional/border wars High external debt, default Commodity price fluctuations |

(d) Framework for Developing-Close Country

Source: Jeffrey D. Simon, "A Theoretical Perspective on Political Risk," Journal of International Business Studies, Winter 1984, P.123-141.

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